COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Boston Edison Company	)	
Cambridge Electric Light Company	)	D.T.E. 03-47
Commonwealth Electric Company	)	
NSTAR Gas Company	)	

INITIAL BRIEF OF BOSTON EDISON COMPANY, CAMBRIDGE ELECTRIC LIGHT COMPANY, COMMONWEALTH ELECTRIC COMPANY AND NSTAR GAS COMPANY

Submitted by:

Robert J. Keegan, Esq.
Robert N. Werlin, Esq.
Stephen H. August, Esq.
Keegan, Werlin & Pabian, LLP
21 Custom House Street
Boston, MA 02110

Dated: August 19, 2003

TABLE OF CONTENTS

COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Boston Edison Company Cambridge Electric Light Company Commonwealth Electric Company NSTAR Gas Company	)	D.T.E. 03-47

INITIAL BRIEF OF BOSTON EDISON COMPANY, CAMBRIDGE ELECTRIC LIGHT COMPANY, COMMONWEALTH ELECTRIC COMPANY AND NSTAR GAS COMPANY

In this proceeding, the Department of Telecommunications and Energy (the "Department") is reviewing the tariff proposal of Boston Edison Company ("Boston Edison"), Cambridge Electric Light Company ("Cambridge"), Commonwealth Electric Company ("Commonwealth") and NSTAR Gas Company ("NSTAR Gas") (together, "NSTAR" or the "Company") to establish a reconciling rate-adjustment mechanism to recover expenses associated with the Company's obligation to provide employees and retirees with pension benefits and post-retirement benefits other than pensions. The Company has established, by record evidence, that the mechanism is a necessary and appropriate ratemaking approach that protects the interests of customers, avoids unnecessary financial harm to the Company and its customers and gives effect to the Department's accounting ruling in D.T.E. 02-78. For the reasons described in this initial brief, the proposed tariffs should be approved by the Department.

I. INTRODUCTION

In December 1985, the Financial Accounting Standards Board (the "FASB") issued Statement of Financial Accounting Standards No. 87 ("SFAS 87"), which established new financial accounting standards, to become effective in 1987, that significantly changed the manner by which companies account for their obligations relating to employee pensions (Exh. AG-1-34, Attachment 34(a), at 1).[1] Similar accounting requirements were contained in the Statement of Financial Accounting Standards No. 106 ("SFAS 106") governing accounting practices for post-retirement benefits other than pensions ("PBOPs"), which the FASB issued in December 1990 to become effective in 1993 (Exh. AG-1-35, Attachment AG-1-35, at 1).[2] Since that time, both the Department and regulated utilities have struggled with the ratemaking implications of the accounting requirements for pension and PBOP expense. As the Department has recognized, in several instances, that the components of the calculation of pension and PBOP expense under SFAS 87 and SFAS 106 tend to exhibit a level of volatility even without the existence of unfavorable or unusual circumstances in the financial markets (Exh. NSTAR-JJJ, at 23-27, and case cited therein). The economic circumstances experienced in the past few years have served only to further expose the inherent conflict between accounting requirements (which dictate a company's expense levels), the requirements of the Employee Retirement Income Security Act ("ERISA"), which are administered by the Internal Revenue Service (and affect trust-fund contribution levels), and ratemaking policies and practices (which are designed to include a "representative" level of pension and PBOP costs in rates).

---

1 Prior to the commencement of FAS 87, there was no consistent standard to guide the derivation of pension expense.

2 The changes to FAS 106 required companies to book amounts based on the accrual of the amount needed to fund the future level of employee benefits during the working lives of the employees, rather than recognizing expense levels based on amounts paid out to retirees in a particular year, i.e., on a "pay as you go" basis (Exh. NSTAR-JJJ, at 10-11).

The Company's proposal attempts to provide the Department with mechanism to resolve the conflict between these competing factors. Specifically, since 1987, the NSTAR operating companies in aggregate have expensed $450 million, while recovering $437 million in rates and making cash contributions of $930 million to its pension and VEBA trust funds. See, Exh. RR-AG-1. As of December 31, 2002, this framework produced a prepaid pension balance of approximately $257 million on the Company's books. Because the value of the Company's pension trust-fund assets were estimated to fall below the accumulated benefit obligation as of December 31, 2002, accounting rules would have required the Company to record an Additional Minimum Liability ("AML") of $435 million as of December 31, 2002. Exh. NSTAR-JJJ, at 15. In addition, generally accepted accounting practices would have required the Company to take a charge against equity for the AML, as well as any pension and PBOP prepayments, at the end of the fiscal year. In order to avoid the required charge to equity, the Company requested on November 27, 2002, that it be authorized by the Department to implement two accounting practices:

1. the deferral and recording on the Company's books as a regulatory asset or liability, of the difference between the level of the pension and PBOP expenses that are included in rates and the amounts that must be booked in accordance with SFAS 87 and SFAS 106; and

2. the deferral and recording on the Company's books as a regulatory asset the amount of the Company's current and future Additional Minimum Liability[3] that must be booked in accordance with SFAS 87and SFAS 106.

3 The Additional Minimum Liability represents the amount by which the Company's pension plan obligations exceed the value of the assets in the trust fund at the end of each calendar year (Exh. NSTAR-JJJ, at 14-15).

The record shows that, absent the approval of the establishment of the requested regulatory assets, the Company would have had to take a charge to its common equity of approximately 20 percent of its total book equity (Exh. NSTAR-JJJ, at 15; Tr. 1, at 21 [Judge]). As described below, each of these requests arose from specific accounting rules and their application by the Company's independent auditors, PricewaterhouseCoopers LLP ("PwC"), to the Company's financial statements (see e.g., Exh. PwC-RJS, at 3-4; Exh. AG-2-6, Attachment AG-2-6; Exh. NSTAR-JJJ, at 2). The need for the accounting ruling was precipitated by the combination of applicable accounting requirements, the decline in financial markets and the cascading effects of this decline, which: (1) reduced the value of the assets held in trust to meet pension obligations; (2) reduced the projected earnings of the pension/PBOP trust funds; and (3) reduced the discount (interest) rate used to calculate the net present value of the future stream of payments made to or on behalf of the Company's current and future retirees, requiring greater cash contributions to meet future obligations (Exh. DTE-2-7, Attachment DTE-2-7).

The Department granted the Company's requested accounting ruling on December 20, 2002 in Approved Request For Accounting Ruling, D.T.E. 02-78 (2002). As indicated in the request for the ruling, the Company was also required to seek the implementation of a specific ratemaking mechanism to give effect to the accounting ruling and to maintain the regulatory assets (Exh. NSTAR-JJJ, at 2; Exh. PwC-RJS, at 4-5). The Company's tariff filing in this case proposes to establish a ratemaking mechanism for reconciling and recovering costs associated with pension and PBOP obligations over the long term. The proposed, fully reconciling adjustment mechanism would reduce volatility for both customers and the Company (Exh. NSTAR-JJJ, at 3; Tr.

1, at 66-68 [Judge]), ensure that customers pay no more and no less than the amounts needed to provide pension and PBOP benefits to the Company's retirees (Exh. NSTAR-JJJ, at 3) and avoid impairment of the Company's financial integrity (id.).

As described below, the conflict between ratemaking, accounting and tax requirements for funding of pension and PBOP benefits calls for the establishment of a ratemaking approach that will provide consistency from a policy perspective, will smooth the effects of volatility in expense levels for both customers and the Company and will ensure that significant negative financial impacts to both the Company and its customers are avoided. In that regard, the Company has demonstrated on this record that approval of the reconciliation mechanism proposed by NSTAR will meet these objectives and is necessary to give effect to the Department's accounting order in D.T.E. 02-78 and to ensure that customers pay only the costs that are necessary to meet the Company's obligations to employees and retirees.

II. PROCEDURAL HISTORY

On April 16, 2003, the Company submitted tariffs to the Department for each of its four regulated operating companies, together with prefiled testimony and supporting exhibits (the "Filing"), for approval of a pension/PBOP reconciliation-adjustment mechanism ("PAM") to provide for the recovery of expenses associated with the Company's obligations to provide pension benefits and PBOPs to retirees. On April 23, 2003, the Department suspended the effective date of the tariffs until August 1, 2003, in order to investigate the propriety of the Company's proposed tariffs. On June 13, 2003, the Department further suspended the effective date of the tariffs until October 1, 2003. Intervenor status was granted to the Attorney General of the Commonwealth ("Attorney

General”). Western Massachusetts Electric Company, KeySpan Energy Delivery New England, Massachusetts Electric Company, Fitchburg Gas and Electric Light Company, and Associated Industries of Massachusetts were granted limited participant status (Tr. June 12, 2003, at 11-12).

On June 5, 2003, the Attorney General filed a motion to dismiss the Company’s Filing (“Motion to Dismiss”). The Attorney General also requested that the Department stay the ongoing proceedings until a decision was issued on the motion to dismiss. The Company filed its opposition to the Motion to Dismiss on June 12, 2003. The Attorney General replied to the Opposition on June 20, 2003. On August 7, 2003, the Department denied the Attorney General’s Motion to Dismiss. Interlocutory Order on Motion to Dismiss, D.T.E. 03-47, at 8 (August 7, 2003).

In support of the Company’s proposed Pension/PBOP Adjustment Mechanism, the Company sponsored the direct testimony of James J. Judge, Senior Vice President, Treasurer and Chief Financial Officer of NSTAR and each of its four regulated distribution companies. The Attorney General submitted the prefiled testimony of David J. Effron. Robert J. Spear, partner of PwC, testified concerning the accounting relating to the Department’s Order in D.T.E. 02-78 and the accounting related to the Company’s proposed reconciliation mechanism for pension/PBOP costs. Evidentiary hearings on the Company’s proposal were held at the Department on August 6 and 7, 2003. The Company and PwC responded to 61 and seven information requests from the Attorney General, respectively. The Company responded to 44 information requests from the Department. The Attorney General also responded to 19 information requests from the Company. All responses to information requests were entered into the record (Tr. 2, at 284-285), as well the pre-filed testimony, four additional exhibits marked by the Company, one additional exhibit marked by the Attorney General and one exhibit marked by the Department. The Hearing Officer established a briefing schedule of simultaneous initial briefs on August 19, 2003 and reply briefs on August 28, 2003.

III. BACKGROUND

A. Accounting for the Difference Between Pension/PBOP Expense and Amounts Included in Base Rates.

The accounting treatment for costs incurred to provide employees and retirees with pension and PBOP benefits changed significantly as a result of the issuance by the FASB of SFAS 87 and SFAS 106, which were implemented in 1985 and 1990, respectively. Earlier accounting treatment varied from company to company, with a wide variety of measurement methods and assumptions being used to determine a company's pension obligations (Exh. NSTAR-JJJ, at 10). Similarly, prior to the issuance of SFAS 106, most companies accounted for their pension and PBOP obligations on a "pay as you go" basis, with medical and life-insurance benefits for retirees being expensed on a company's books as they were paid out to retirees. Through the issuance of SFAS 87 and SFAS 106, the FASB established a systematic method for recognizing its employees' future retirement benefit costs as they accrued over each employee's working life (id. at 11). Under these standards, the pension and PBOP obligations that accrue over the working life of each employee are offset by the earnings on the funds that are set aside specifically to provide the funding of those benefits (id.; Exh. AG-1-34, Attachment AG-1-34(a); Exh. AG-1-35, Attachment AG-1-35).

As a result of SFAS 87 and SFAS 106, future pension and PBOP obligations (and the corresponding accounting treatment) are computed based on complex actuarial studies that are designed to calculate the company's long-term obligations to its retirees based on numerous assumptions, including the work longevity of employees, the projected cost of health care when employees are retired, and the expected long-term rate of return on the assets held by the plan (see, e.g., Exh. DTE-2-7, Attachment DTE-2-7). A portion of this total obligation accrues on an annual basis for each employee. As the working assumptions change over time (e.g., reductions in the anticipated long-term rate of return on assets held in the plan), a company's annual obligation also must change accordingly to reflect new expectations about the amount of funds that must be contributed to assure sufficient future assets to cover the company's obligations to its retirees.

As a result of the changes in accounting rules beginning in 1987, the Department and regulated companies have struggled over how best to deal with pensions and PBOP expenses.[4] The Department precedent has been inconsistent in determining how best to include a "representative" level of pension and PBOP expenses in base rates (Exh. NSTAR-JJJ, at 23-27; Tr. 1, at 42-43 [Judge]). Contributing to this inconsistent treatment is the fact that there are differences in the accounting requirements under SFAS 87 and SFAS 106, and the amounts actually contributed by companies, which are, in part, affected by the tax-deductible limits on company contributions under the requirements of ERISA, as administered by the Internal Revenue Service ("IRS"). The ERISA/IRS rules

[4] As with other costs associated with employees, a portion of the costs incurred by companies for pension and PBOP benefits are capitalized and placed in rate base. Fitchburg Gas and Electric Light Company, D.T.E. 02-24/25, at 116 (2002); Berkshire Gas Company, D.T.E. 01-56-A at 22-23 (2002). Thus, the capitalized portion of the pension and PBOP costs are recovered over time, and therefore, it only the non-capitalized "expense" portion of the total pension and PBOP costs that is the subject of the Company's proposal.

have created a disparity between amounts contributed to the Company's pension and PBOP plans on a tax-deductible basis, and the annual pension and PBOP liability booked by the Company in accordance with SFAS 87 and SFAS 106 (Exh. NSTAR-JJJ, at 13-14).

The most significant difference between the ERISA/IRS tax-deduction rules and the FASB accounting rules involves the impact of the "funded status" of the plan on the calculation of the Company's annual pension "obligation" (Exh. NSTAR-JJJ, at 13). As noted above, the IRS and the FASB have adopted different calculations to determine where a company stands at any given point in time concerning the funded status of its pension and PBOP plans. The maximum *tax-deductible contribution* each year is based on the "unfunded current liability" as defined by the IRS. Therefore, the decrease or increase in the funded position of the plan is immediately reflected in the calculation of the IRS maximum and minimum contribution level (id.).[5] However, under the FASB accounting rules, the changes in plan liabilities and assets are always recognized through an amortization of the expense over time. Simply put, the IRS "recognizes" funding liabilities more quickly than the FASB, which spreads identified funding deficiencies over a period of time, thereby "smoothing" the ups and downs attributable to a pension's funding status. The timing differences that occur between the funded amount (as constrained by the IRS maximum contribution calculation) and the expense amount (as specified by the FASB) often lead to a prepaid balance (i.e., where the cumulative cash

5 Contributions that fall below the minimum levels established under the ERISA may lead to the assessment of penalties by the IRS.

contribution is greater than the cumulative FASB cost), or a liability on the company's books (when the cumulative cash contribution is less than the cumulative FASB cost).

Rapidly changing SFAS 87 and 106 obligations, together with IRS rules that diverge from the FASB requirements concerning the funding and deductibility of plan funding levels, have made it increasingly more difficult to identify a representative level of pension and PBOP expense to be included in its base rate revenue requirement calculation. Large differences between test-year amounts and actual amounts required to be booked as SFAS 87 and SFAS 106 expense particularly have occurred in recent years as the effects of a declining stock market and interest rates have taken their toll on the value of pension and PBOP plans.

Since the implementation of SFAS 87 and SFAS 106, the Department has faced a difficult challenge to develop a ratemaking rule that would reflect a representative level of pension and PBOP expense. After reviewing the available alternatives in 1992, the Department concluded that using funding levels equal to the tax-deductible amount represented the best balance of competing interests.[6] Massachusetts Electric Company, D.P.U. 92-78, at 83 (1992). Because Massachusetts Electric Company made a cash contribution to its VEBA trust fund in excess of the level of expenses based on SFAS 106, the Department required a four-year phase in to the full IRS tax-deductible amount, allowing carrying costs using the allowed rate of return on the deferred amounts.

---

6 Since that time, the Department has reiterated that "it does not endorse any specific ratemaking method for the calculation of pension expense for ratemaking purposes" and that "the intricacies of this issue warrant an investigation on a case-by-case basis." See, e.g., Boston Gas Company, D.P.U. 96-50, at 81 (Phase I) (1996). The statement highlights the difficulty the Department has faced since the implementation of SFAS 87 and SFAS 106 in crafting a standard ratemaking approach to this issue. In fact, pension expense is the only instance in which the Department has used cash outlays as a proxy for expense.

Id. at 84. In a subsequent decision, the Department found that the average of the historical five-year pension contributions is the appropriate measure in determining the level of pension expense to be included in rates. Boston Gas Company, D.P.U. 96-50-C at 42-43 (1997). However, in Mass-American Water Company, D.P.U. 95-118, at 111 (1996), the Department based the company's allowable pension expense on a four-year average of actual cash contributions, rather than the five-year average allowed in D.P.U. 96-50-C.

Six years later in 2002, the Department appeared to reverse its earlier holding, and concluded that "if a company does not make any pension contributions during the test year, the Department will not include *any* pension expense in the cost of service." Fitchburg Gas and Electric Light Company, D.T.E. 02-24/25, at 111 (2002). Notwithstanding the varying ratemaking treatment accorded to SFAS 87 and SFAS 106, the Department has approved fully reconcilable post-divestiture SFAS 87 and SFAS 106 amounts. For example, Boston Edison Company's Restructuring Settlement Agreement provides that the total "post divestiture" SFAS 87 and SFAS 106 gains or losses recognized on Boston Edison's books "shall be reflected in distribution rates to customers *and shall neither be retained nor borne by [Boston Edison]*" (i.e., fully reconcilable). Boston Edison Company Restructuring Settlement Agreement, at 8 ftnt.5, as approved by the Department in Boston Edison Company, D.P.U. 96-23 (1998) (emphasis added). See also Massachusetts Electric Company Restructuring Settlement Agreement, as amended, Massachusetts Electric Company, D.P.U. 96-25-A (1997) (Department approves agreement with same provision to that approved in Boston Edison Company, D.P.U. 96-23).

The difference between the amounts booked under the FASB accounting rules and the amounts actually contributed by companies (which are greatly influenced by ERISA and IRS rules) largely represents a timing difference (Exh. NSTAR-JJJ, at 14) that will reconcile over the long term. However, the Department's varied precedent, which focuses on recent cash contributions as a proxy for representative expense levels, does not address the ramifications that result from the inherent conflict between FASB, IRS, ERISA and DTE rules. A disparity exists between the amounts recovered in the Company's rates and the booked expense, as well as the amounts that the Company is required to contribute in cash to meets its obligations. This differential has risen to extreme levels in the last year and a reconciliation mechanism is a necessary and appropriate means of addressing this increased volatility and the potential charges to equity that result therefrom.

B. Accounting for Prepayments and Additional Minimum Liabilities

NSTAR sponsors the NSTAR Pension Plan, a defined benefit pension plan that covers approximately 3,000 employees and 4,000 retirees and their beneficiaries (Exh. NSTAR-JJJ, at 4). In addition, the Company provides post-retirement health and life-insurance benefits to its retirees under the Group Welfare Benefits Plan for Retirees of NSTAR. As of December 31, 2002, the Company's pension and PBOP plans had the following asset and liability balances:

	Pension	PBOP
Accumulated Benefit Obligation	$844 million	$572 million
Asset value	$666 million	$215 million

The accumulated benefit obligation ("ABO") is the actuarial present value of the total cost of pension and PBOP benefits attributed to service provided by employees to date without taking future compensation increases into account. Under SFAS 87, a company is required to compare the fair value of its plan assets and the amount of the ABO as of the end of each year (Exh. NSTAR-JJJ, at 14). If the ABO exceeds the asset value, then the plan is said to have an "unfunded ABO." The minimum pension liability balance that must be reflected on a company's books is the amount of the ABO. For NSTAR, its unfunded ABO as of December 31, 2002 was $178 million ($844 million ABO less $666 million of plan assets) (id. at 15).

SFAS 87 requires that the Company "recognize" on its books an Additional Minimum Liability ("AML") if the Company's pension liability (reflecting incremental employee benefit accruals for the year): (i) is lower than the unfunded Accumulated Benefit Obligation; or (ii) if the Company has a prepaid pension balance on its books (id.). Because NSTAR has a prepaid pension balance on its books (the difference between cash contributions and SFAS 87 booked amounts), the amount of the adjustment required to reflect the Additional Minimum Liability is the amount of the prepaid balance *plus* the *unfunded* Accumulated Benefit Obligation.

As required by SFAS 87, NSTAR recorded on its books in 2002 the amount of its unfunded Accumulated Benefit Obligation of $178 million. As described above, however, because of this unfunded ABO, the Company was required to recognize an Additional Minimum Liability equal to the sum of the unfunded ABO and the prepaid balance (id.). This resulted in an AML adjustment of approximately $435 million, which is reflected on the Company's books as follows:

AML regulatory asset	$168.8 million
Prepaid regulatory asset	257.0 million
Allocated to unregulated companies	7.9 million
Intangible Asset	1.0 million[7]
Total AML Adjustment	$434.7 million

(id.). SFAS 87 requires a company to take a charge (i.e., write-down) to common equity net of taxes, through other comprehensive other income, for the remaining AML after recognition of the intangible asset. The Department's accounting ruling in D.T.E. 02-78 allowed the Company to record a regulatory asset on its books in lieu of a charge to equity to reflect the effect of the AML (after allocation to the unregulated companies) (id. at 16). However, based on Mr. Spear's professional view of the FASB requirements, the Department's accounting ruling does not allow the Company to record this regulatory asset indefinitely into the future. According to Mr. Spear, the characteristics of a mechanism that must be in place include having a period of recovery that is not open ended and the recovery of accrued deferrals occur over a reasonable period, which Mr. Spear testified would be a three-to-five year period (Tr. 1, at 121 [Spear]). Accordingly, the Company's Filing in this case is focused on a rate reconciliation mechanism that will allow the Company to continue to record a regulatory asset as the Company is able to recover such amounts over time through the PAM.

[7] Under SFAS 87, a company is permitted to recognize an intangible asset on its books as part of the AML adjustment to the extent that it has unrecognized transition obligation or unrecognized prior service losses. At December 31, 2002, this amount was $980,000 for NSTAR (Exh. NSTAR-JJJ, at 15-16).

C. The Company's Proposed Resolution

There is no dispute in this proceeding that the Company's reasonable and prudently incurred costs to meet its obligation to provide pension and PBOP benefits to its employees and retirees represent legitimate and reasonable expenditures that are an appropriate component of the cost of service and that are recoverable from customers through rates (Tr. 2, at 212-213 [Effron]). Moreover, the record for the proceeding shows that, if the Department's accounting order is to be given effect and the negative impacts associated with a charge to equity are to be avoided, recovery of all deferred pension/PBOP costs will need to commence within months and be concluded within a reasonable period of time (Tr. 1 at 153, 162, 182). However, the numerous ratemaking iterations implemented by the Department over the last 10 to 15 years demonstrate that, even under more stable economic conditions, selecting a representative level of pension and PBOP expense for inclusion in base rates involves the difficult challenge of addressing the conflicting accounting, tax and ratemaking requirements. In fact, the problems inherent in treating the long-term funding of the Company's pension and PBOP plans as a "normal" short-term cost-of-service expense precipitated the need for the Company to request relief from the Department in November 2002, in order to avoid substantial, detrimental financial impacts associated with a significant charge to equity.

The Company's proposal to implement a reconciling mechanism for the recovery of pension and PBOP expenses accomplishes two major objectives that are not currently satisfied through the traditional base-rate treatment of these expenses. First, the Company's proposed ratemaking mechanism would ensure that customers pay no more and no less than the amounts actually needed to provide pension and PBOP benefits to employees as the Department seeks to address cost-recovery issues associated with the deferral granted to the Company and the substantial fluctuations in pension expense that will occur over time (Exh. NSTAR-JJJ, at 28-29). This objective is particularly significant in light of the past difficulty of identifying an appropriate and reasonably representative level of costs to be included in rates. In addition, the more timely, incremental annual adjustments under the PAM are consistent with the Department's rate continuity goals because it avoids large "step" changes when a company files for a general rate case every few years (Tr. 1, at 38-39 [Judge]).[8]

Second, the reconciliation mechanism would ensure that the financial health of the Company is not impaired as a result of the financial reporting and cash-flow issues that arise from the extreme volatility of pension and PBOP funding obligations (id. at 29). This also directly benefits customers because impairment of the financial health of the Company would lead to increases in the cost of capital for the Company, which would be translated into higher distribution rates (Exhs. AG-1-58; AG-1-60).

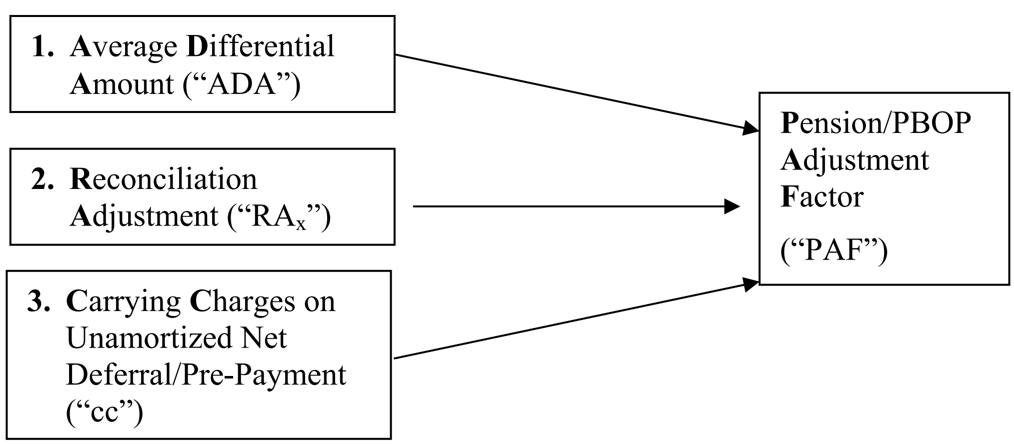
IV. DESCRIPTION OF THE COMPANY'S PROPOSAL

The design of the Company's pension/PBOP cost recovery mechanism is intended to establish an improved ratemaking approach that provides for a more timely recovery of the expenses associated with the Company's pension/PBOP obligations. The pension/PBOP adjustment mechanism is designed to reconcile the annual amounts booked by the Company in accordance with SFAS 87 and SFAS 106 with the annual pension/PBOP expense amount included in the Company's base rates (Exh. NSTAR-JJJ,

[8] In this particular circumstance, approval of the PAM as filed will have the additional customer benefit of avoiding the filing of four base rate cases and larger rate impacts in 2004 (Tr. 1, at 45-46, 67).

at 29). The key to the mechanism is the fact that the amounts booked by the Company in accordance with SFAS 87 and SFAS 106 are designed to reflect the Company's *future* pension and PBOP obligations to its employees and retirees in the calendar year based on a "snap-shot" in time. As conditions change, such as the average life expectancy of employees or the return earned on the plan's assets, the actual costs that will need to be incurred will be adjusted to incorporate the changed circumstances. The long-term, reconciling characteristics of the accounting requirements for pensions and PBOP costs is at odds with the short-term aspects of the way in which the Department's traditional ratemaking approach has dealt with the issue in base rate cases. The proposed mechanism will permit a separate, annual rate adjustment for each distribution company that will permit the reconciliation of the SFAS 87 and SFAS 106 booked expenses, thus avoiding the need for financially crippling charges to equity and the write-off of regulatory assets.

There are three major components to the calculation of the annual adjustment factor:



The Annual Pension/PBOP Adjustment Factor is calculated on an annual basis by summing the Average Differential Amount, the Reconciliation Adjustment and the appropriate Carrying Charges on the Unamortized Deferral and Pre-Paid Amount. In addition, because it is not possible to forecast precisely the number of kilowatthours ("kWhs") (or, for NSTAR Gas, the number of therms) that will be sold, the current year's under- or over-collection of PAM amounts, known as the Past Period Reconciliation Amount, is also included in the total amount to be reconciled in the following calendar year (see, e.g., Exh. NSTAR-1, definition of "$PPRA_x$"; Exh. DTE-1-4(Rev)).

The Average Differential Amount represents the difference between the expense amount of pension and PBOP expenses currently included in the Company's base rates (i.e., the pension and PBOP amounts that were expensed in rates rather than capitalized in base rates) and the three-year average amount (2001 through 2003) of cash contributions funded by the Company for its pension and PBOP plans (Exh. NSTAR-JJJ, at 31). The Average Differential Amount is included in the formula to update the annual pension costs included in the Company's last base rate case to reflect the Company's most recent cash contributions (i.e., amounts contributed after the last rate case) and will continue to be collected on an annual basis going forward until the Company establishes a new base rate amount for pension and PBOP expense.

The Reconciliation Adjustment collects the difference between SFAS 87 and SFAS 106 amounts included in the Company's rates and SFAS 87 and SFAS 106 expense amounts that are being booked by the Company. The adjustment is made through a rolling three-year amortization of this difference, the unamortized balance of which is known as the "Reconciliation Deferral." The difference is added or subtracted from the unamortized balance of the deferral account and the total is amortized over a three-year period. Amortization over a three-year period will allow the Company to recover the Reconciliation Adjustment over time, thereby having the effect of "smoothing" the amount of change in the annual adjustment factor from one year to the next (id. at 32).[9]

For any particular year, the annual difference between SFAS 87 and SFAS 106 amounts currently included in the Company's base rates and SFAS 87 and SFAS 106 expense amounts that are being booked by the Company may be either a positive or negative amount, depending on the amount that the Company is required to book pursuant to the FASB rules to cover its ongoing responsibility to its employees and retirees. Because the level of expenses calculated in accordance with FASB requirements must be "realized" each year, the delay (or customer advance payment) in rate recovery requires the application of carrying charges to ensure that the Company and customers are compensated for the time value of money (id. at 33). The application of carrying charges applies equally in cases where the accounting expenses exceed the levels in rates and in cases where the accounting expenses are less than the levels in rates (i.e., customers would receive the time value of monies advanced above booked amounts) (Exh. DTE-1-7). Therefore, the annual adjustment formula includes a carrying charge factor that is applied to the unamortized balances remaining from the Reconciliation Adjustment. The carrying charge is also applied to Pre-Paid Amounts, which occur when

---

[9] The first year of application of the Pension Adjustment Mechanism to Cambridge will include \$3.7 million in Department-approved deferred SFAS 106 expense as a beginning balance to be amortized in the Unamortized Reconciliation Deferral factor of the PAM (Exh. NSTAR-JJJ, at 32, *citing*, Cambridge Electric Light Company, D.P.U. 92-250, at 54 (1993)). Similarly, Boston Edison customer bills will include \$4.2 million in Department-approved SFAS 87 deferred expense from Boston Edison Company, D.P.U. 92-92 (1993) (Department-approved Settlement Agreement provides for the deferral of the difference between the tax-deductible amount and the SFAS 87 amount) (id. at 33).

the Company has paid funds into the pension/PBOP plans that are greater than amounts required by SFAS 87 and SFAS 106.[10] Applying the carrying charges to these two elements compensates the Company or its customers for the time value of money for the difference between: (a) the amounts paid into the trust funds by the Company; and (b) the amounts collected in rates from customers (Exh. AG-1-30).[11] Thus, both the Company and its customers are "made whole" if there is a timing difference between the collection of revenues in rates from customers and the cash contributions made by the Company to the trust funds.

The level of carrying charges is based on the tax-effected weighted average cost of capital for each distribution company, as most recently applied by the Department. The return for the electric companies is the return on the fixed component of their transition charge as established in each company's restructuring filing (id., *citing* Boston Edison Company, D.P.U./D.T.E. 96-23; Cambridge/Commonwealth, D.P.U./D.T.E. 97-111).[12] The rate of return for NSTAR Gas is the cost of capital used for cash working capital calculations in its cost-of-gas adjustment clause, as approved by the Department in NSTAR Gas' most recent rate case (D.P.U. 91-60) (id.).

---

[10] The carrying charge formula reduces the balance against which customers are responsible for carrying charges by an amount that reflects the deferred taxes associated with the Pre-Paid Amount and the Unamortized Reconciliation Deferral Amount. See Exh. NSTAR-1, Section 1.05.

[11] Even Mr. Effron agreed that "if the [C]ompany demonstrated that from the inception of FAS 87 through the current period that the [C]ompany's pension expense was greater than what it had recovered in rates for pension expense," the prepaid balance would then be a measure of unrecovered cash contributions by shareholders (Tr. 2, at 277-278 {Effron]). The Company has made that demonstration (Exh. DTE-1-2 (rev), Attachment DTE-1-2 (rev), at 1; RR-AG-1).

[12] Because the rates for the three electric companies were established either as part of a settlement or in the context of statutorily mandated rate reductions, the average return on equity is significantly below market returns. For example, the equity return for the largest operating company, Boston Edison, is only 7.99 percent (Tr. 1, at 82 [Judge]).

The annual adjustment factor is fully reconciling; each year each of the distribution companies will file with the Department for a new adjustment factor for the upcoming year. The filing will be made at the time the electric companies submit their annual transition charge reconciliation filing.[13] The factor will compute each component, and the total recoverable amount will be converted into a unit charge by dividing the total dollars to be reconciled by the projected kWh or therms for the upcoming year (Exh. NSTAR-JJJ, at 36).

Because the annual adjustment factor is applied to all sales, and it is not possible to know with certainty what future period sales levels will be, the annual adjustment factor may either over-collect or under-collect the computed pension and PBOP expense amounts. To adjust for these over- and under-collections, the Past Period Reconciliation Amount is included in the calculation of the upcoming annual adjustment factor. Like other reconciliation mechanisms, the pension/PBOP reconciliation is based on a combination of actual and forecasted data for the year in which the filing is made and a final reconciliation will be provided when the data from each year become final.

V. ARGUMENT

This case does not appear to present the Department with a large number of material factual disputes to resolve.[14] Nonetheless, the areas of disagreement, regulatory policy and even the interpretation of accounting rules seem to separate the Company's

---

[13] NSTAR Gas will make its PAM filing in conjunction with its annual Cost of Gas Adjustment and Local Distribution Adjustment Clause reconciliation filing.

[14] NSTAR makes this statement based on Mr. Effron's testimony, the questioning of Messrs. Judge and Spear and the issues that have already been resolved by the Department in its Order denying the Attorney General's Motion to Dismiss. If the Attorney General raises additional disputes in his initial brief, the Company will address those issues on reply brief.

position from that of the Attorney General. Without trying to anticipate every argument to be made by the Attorney General, the remainder of this brief will address the appropriate standard of review for Department consideration of the Company's proposal, how the record evidence presented by the Company fully meets the Department's standard and why the Attorney General's criticisms are without merit.

A. Standard of Review for Adoption of a Reconciliation Mechanism.

The establishment of reconciliation mechanisms is not a new concept in utility regulation or for the Department. More than 25 years ago, the Supreme Judicial Court ("SJC") considered the purpose of cost-adjustment clauses, and stated the advantages that such clauses provide by reconciliation of costs outside the calculation of traditional base rates.

> Rate proceedings have been notoriously slow as well as expensive. . . . Therefore the demand arose to build into the rates, provisions by which increases in certain costs to the utilities (and, to be fair, decreases as well) would in accordance with formula[e] be automatically passed on to the consumers as fluctuations of the charges to them, without the burden and expense to utilities – which would ultimately fall upon consumers – of instituting and carrying out separate rate proceedings to justify the varying charges.

Consumers Organization for Fair Energy Equality v. Department of Public Utilities, 368 Mass. 599, 606 (1975). The SJC reasoned that automatic adjustment held particular appeal "where the utility had only minimal bargaining power about the particular items of cost (e.g., a gas company purchasing natural gas from a supplier whose rates were fixed by the Federal Power Commission) . . ." Id.

Similarly, the Attorney General has previously recognized the benefits of adopting reconciliation mechanisms. According to the Attorney General, the characteristics of utility costs included in reconciliation adjustment mechanisms are those that:

> (1) are a significant part of a utility's cost of doing business; (2) vary significantly over relatively short time intervals; and (3) are substantially not within a utility's control.

Bay State Gas Company, D.P.U. 94-16, at 41 (1994).

The Attorney General's stated criteria for the use of a reconciliation mechanism, as described in Bay State Gas Company, D.P.U. 94-16 (1994), are similar to the criteria stated by the Department when it first established a cost-of-gas-adjustment mechanism for pipeline gas costs several years after interstate pipelines were first constructed to serve New England. Worcester Gas Light Company, 9 P.U.R. 3d 152 (1955) ("Worcester"). In Worcester, the Department stated that the principal reasons it allowed such an adjustment clause was the realization that "fuel prices were and are relatively volatile" and that such fuel costs represented a substantial cost. Id. at 155. A further consideration offered by the Department was the fact that "a relatively slight increase in the cost per Mcf of purchased gas would, even after taxes, materially affect the companies' net earnings." Id. In addition, the Department consideration in favor of approving the adjustment clause was attributable to the generic effect such costs might have on other utilities in the Commonwealth. The approval of the reconciliation mechanism would therefore avoid substantial cost and delay. The Department would otherwise have had to engage itself in:

> a very long and protracted series of rate hearings occupying a substantial length of time, involving substantial expense to both the companies and to the [C]ommonwealth and orders in which would necessarily, unless they were all issued at one time, prejudice one company as against another. It does not seem to us that either good regulation or common sense requires this result . . .

Id. at 156.

The Attorney General's stated criteria for the use of a reconciliation mechanism are also similar to the criteria stated by the Department in establishing a mechanism for the recovery of cleanup expenses relating to manufactured gas wastes, which were expected to be extraordinary in nature and amount. See, Manufactured Gas Site Cleanup, D.P.U. 89-161, at 52 (1990). In that case, the Department found that:

> [C]leanup expenses relating to manufactured gas wastes can reasonably be predicted to recur over the next several years. Unlike rent, wages or other periodically recurring expenses, it is not possible to derive a representative level of cost for MGP cleanup activities because the precise amount of the expense and its periodicity are subject to significant uncertainties, largely outside the control of the companies.

D.P.U. 89-161, at 52.

Thus, the factors that the Department considers in determining whether an expense category should be recovered as part as a reconciliation mechanism include the financial impact of the expense on the company (including the size and volatility of the cost), the degree to which the Company has to opportunity to control the cost category and whether approval of a separate adjustment clause will avoid otherwise unnecessary general rate proceedings. As described below, the Company has established on the record in this case the presence of all factors that under the Department precedent would justify the approval of the proposed PAM.

B. The Record in This Case Justifies the Proposed Pension/PBOP Adjustment Mechanism.

1. The Approval of the Proposed PAM Avoids Significant and Adverse Financial Impacts on the Company and Its Customers.

In the absence of the proposed PAM, the Company and its customers will face detrimental (and unnecessary) financial consequences relating to an extraordinary charge against common equity[15] and the write-off of regulatory assets (Tr. 1, at 83-84 [Judge]). As described in Exhibit AG-1-58:

> The existing accounting deficiency in the NSTAR pension fund could result in an impending charge to common equity if there is no specific approved rate-recovery mechanism to be implemented by January 1, 2004. This situation would have a detrimental effect on NSTAR's financial health as follows: (1) the Company's bond ratings are likely to be downgraded, which will increase the costs that the Company will incur to raise capital and finance utility operations; (2) the Company's credit agreements may be negatively affected by a downgrading, which could further impair the Company's access to capital to continue financing system improvements and fund utility operations; and (3) the Company's stock price would likely suffer, which would increase future costs of equity.[16]

It is hard to overstate the magnitude of the negative financial impact without approval of the proposed PAM. At the end of last year, the total before-tax AML adjustment without the accounting ruling by the Department would have been approximately $435 million (Exh. NSTAR-JJJ, at 15). The Company's pension/PBOP estimated expense for 2003 ($64.4 million (Exh. DTE-1-3(Rev))) is a significant amount for a company the size of NSTAR.[17] In fact, in the absence of approval of a separate adjustment mechanism, the Company would be forced to file four individual general rate cases; the pension/PBOP expense is the "major driver" of the rate cases, constituting one-half of the revenue deficiency (Tr. 1, at 45-46 [Judge]).

---

15 The Company will address below Mr. Effron's "whistling past the graveyard" opinion that the Company would not have had to take a quarter-billion dollar charge to equity, if it had simply ignored the problem and failed to ask for the accounting ruling from the Department in D.T.E. 02-78.

16 As indicated above, all of these negative impacts flow through to customers, largely in the form of higher costs for the Company to attract capital and more volatility in distribution rates (Exh. AG-1-60).

17 The Company's total, non-tax O&M costs for the year 2002 were $432 million with net income of $164 million (Exh. AG-1-7(6), Attachment AG-1-7(6)).

The Attorney General's witness, Mr. Effron, refuses to acknowledge that the Company would be required to take the charge to equity if the Department had not approved the accounting ruling in D.T.E. 02-78 (Exh. AG-2, at 9; Tr. 2, at 233 [Effron]). Mr. Effron maintained this position in the face of contrary and unambiguous testimony presented by Mr. Spear, the engagement partner for the Company's independent auditors (Exh. PwC-RJS, at 3-4; Tr. 1, at 147 [Spear]; see also Exh. AG-2-6, Attachment AG-2-6 (contemporaneous internal memoranda of PwC)).

With all due respect to Mr. Effron, his testimony on this issue should be accorded no weight by the Department. Mr. Effron operates a one-person consulting business (Tr. 2, at 211 [Effron]). Mr. Effron has not worked for an audit firm for nearly 30 years (Exh. NSTAR-1-4, Attachment NSTAR-1-4) and during that period he never rendered an opinion on financial statements (Exh. NSTAR-1-8). His audit engagements also did not include any regulated utilities (Exh. NSTAR-1-9). He has never prepared a financial statement for the Securities and Exchange Commission (Exh. NSTAR-1-10). He has never prepared a financial statement for the Federal Energy Regulatory Commission (Exh. NSTAR-1-11). He has never prepared a financial statement subject to the requirements of SFAS 71 (Exh. NSTAR-1-12). He is not an attorney, expert statistician or certified actuary (Tr. 2, at 209-210 [Effron]). In sum, Mr. Effron has no expertise to render an "opinion" as to whether NSTAR was and is required to take a charge against common equity in the absence of the accounting ruling in D.T.E. 02-78 or the implementation of an appropriate reconciliation mechanism.[18]

The Company has, therefore, demonstrated that, absent the approval of an appropriate reconciliation mechanism (i.e., the proposed PAM), the Company and its customers will sustain significant and adverse financial consequences.

2. The Approval of the Proposed PAM Mitigates the Volatility of Pension/PBOP Expense, Which Is Outside of the Company's Control.

The level of pension and PBOP expense that NSTAR is required to recognize in any given year is a function of accounting requirements, and not of the Company's own actions. As described by Mr. Judge:

> The FASB expense for 2003, as I mentioned, for both pension and post-retirement benefits is about $64 million. The similar number for 2002 would be closer to $30 million. That, I think, evidences the reason that the company's come forward with this proposal. We've seen those costs go from $90 million in 1996 to nearly zero in 2000, back up to $90 million in 2003; extreme volatility, well beyond anything that the company could possibly manage.

(Tr. 1, at 26-27 [Judge]; see also Exh. DTE-1-2 (rev)). The record shows that the pension and PBOP expense recognized by the Company results from a calculation that is prescribed by accounting requirements, which are designed to reflect, among other things, the amortization of gains and losses in the fund over the working lives of

18 Even if the Department were to consider Mr. Effron's opinion, his opinion cannot outweigh the testimony presented by Mr. Spear of PwC. PwC is the actual auditor of the financial statements of the Company and must render formal, independent audit opinions regarding those financial statements (Tr. 1, at 108 [Spear]). The record is clear about the view of Mr. Spear and of senior consulting partners at PwC regarding whether accounting rules require a charge to equity in these circumstances (Exh. PwC-RJS, at 3-4; Tr. 1, at 147 [Spear]; see also Exh. AG-2-6, Attachment AG-2-6 (contemporaneous internal memoranda of PwC)).

employees. These components of the expense cause the expense level to be largely unpredictable and outside of the control of the Company (Tr. 1, at 73 [Judge]).

Mr. Judge also explained the way in which the application of mandated accounting standards, when coupled with financial market changes, creates large swings in what must be booked for accounting purposes. For example, in addition to the Company's consideration of the projected pension and PBOP obligations to its employees and retirees, the actual trust asset balance must be considered in calculating the net funded status and the net expense of the Company's pension/PBOP plans (Exh. NSTAR-JJJ, at 9). The expected long-term rate of return on the assets is calculated each year as an offset to the plans' costs. However, as Mr. Judge states:

> many of the FASB-required underlying assumptions and projections (especially with respect to future market returns and interest rates) can be very volatile and uncertain, and have significant impacts on the funded status of pension and PBOP plans for financial reporting purposes. These assumptions also drive the accounting that is required to reflect the funded status of a company's pension plan.
>
> Id. at 9-10.

The proposed PAM tariffs ease the impact of the volatility of pension and PBOP expenses for the Company and its customers. For customers, the PAM will reconcile the costs and revenues so that customers pay only the amounts necessary for the Company to fulfill its pension and PBOP obligations. Rather than large and "permanent" changes in cost recovery established through general rate cases, the three-year amortization of the difference between the SFAS expense and the amount being collected in rates systematically phases-in rate changes annually. Rates in the future will rise and fall more gradually and with certainty, thus reducing rate volatility and protecting customers from overpaying. The Company's earnings and equity are protected from the volatile swings in financial markets that cause large changes in earnings and charges to equity, as are mandated by accounting rules. The implementation of a reconciling rate mechanism will permit the Company to continue to defer expenses as regulatory assets, thus eliminating a detrimental financial impact. As described above, this Company benefit also directly benefits customers, because avoiding the adverse impact on earnings and equity will prevent a rise in the cost of capital and the resulting rate increase to customers.

3. The Approval of the Proposed PAM Avoids Unnecessary Rate Cases Over the Short and Long Term.

Without a separate mechanism to adjust rates to provide for the timely recovery of expenses relating to the Company's pension and PBOP obligations, changes in volatile financial markets will force a series of unnecessary general rate cases. When markets deteriorate, as has been the case over the past three years, the increased expense would force the Company to file general rate cases to recover the increased costs. In the absence of approval of the PAM tariffs, the immediate filing of four rate cases is the only option available to the Company over the short term (Exh. DTE-2-1). Over the long term, the lack of a separate reconciliation adjustment mechanism would likely trigger a series of rate cases. If financial markets deteriorate further, the Company would be required to file more general rate cases in order to recover its costs. If financial markets improve (and the level of pension and PBOP expenses decline), the Attorney General or the Department would likely trigger rate cases so that rates could be reduced.

This endless cycle of unnecessary and costly rate cases benefits noone. For example, customers will be harmed if the Company were forced to file for immediate general rate relief. Although the Company would forgo the filing of general rate cases if the PAM is approved as filed, if it must file general-rate cases, customers would pay higher rates to reflect increases in costs unrelated to pensions and PBOP obligations (Tr. 1, at 45-46 [Judge]). In fact, before adjusting for "known and measurable" cost increases, the returns on rate base for each of the distribution companies for 2002 indicate the need for significant rate relief (Exh. AG-1-10).[19] Although acknowledging that he does not claim "conclusively" that the Company has a revenue excess, Mr. Effron calculates a "return on average common equity" of 14.0 percent (Exh. AG-2, at 8). However, this is a meaningless number. A revenue deficiency or excess, as computed by the Department for regulatory purposes, is the return on rate base. See, e.g., Fitchburg Gas and Electric Light Company, D.T.E. 02-24/25, at 304 (2002). Even Mr. Effron agrees that the calculations are different (Tr. 2, at 251 [Effron]). In addition, the Attorney General has a statutory right to a hearing to propose rate reductions, if he believes that the Company is earning more than a reasonable return. G.L. c. 164, § 93.[20]

Over the long term, the filing of unnecessary rate cases will needlessly tax the resources of the Company, the Department and intervenors, and likely divert attention from other, more important issues. Moreover, the administrative costs of the rate cases are borne by customers through rate-case expense and statutory assessments. Fitchburg Gas and Electric Light Company, D.T.E. 02-24/25, at 191 (2002); G.L. c. 25, § 18; G.L. c. 24A, § 3.

Accordingly, the approval of the PAM tariffs will benefit customers over the long and short term by avoiding a series of unnecessary and costly general rate proceedings.

---

19 The computed returns on rate base are: 8.0 percent for Boston Edison, 6.0 percent for Commonwealth, 10.1 percent for Cambridge and 6.6 percent for NSTAR Gas (id.).

20 Of course, instituting such a proceeding could lead to rate increases, if justified by the evidence. Boston Gas Company, D.P.U. 88-67, at 1 (1988).

VI. CONCLUSION

Since the institution of SFAS 87 and SFAS 106, the Department has addressed the issue of including a representative level of pension and PBOP expenses in base rates. The difficulties of this endeavor have been underscored by recent events in financial markets. In this proceeding, the Company has demonstrated the need for approval of its proposed ratemaking mechanism to provide rates and earnings stability, to ensure that customers pay no more or no less than the amounts needed to provide pension and PBOP benefits to employees and retirees, and to avoid the financial impairment of the Company that arise from accounting requirements associated with the extreme volatility of pension and PBOP funding obligations.

Accordingly, the Department should approve the proposed PAM tariffs, as set forth in Exhibits NSTAR-1, NSTAR-2, NSTAR-3 and NSTAR-4.

Respectfully submitted,

BOSTON EDISON COMPANY
CAMBRIDGE ELECTRIC LIGHT COMPANY
COMMONWEALTH ELECTRIC COMPANY
NSTAR GAS COMPANY

By its Attorneys,

____

Robert J. Keegan, Esq.
Robert N. Werlin, Esq.
Stephen H. August, Esq.
Keegan, Werlin & Pabian, LLP
21 Custom House Street
Boston, MA 02110
(617) 951-1400

Dated: August 19, 2003